

JPMorgan Investor Services

thought

IDEAS FOR
A CHANGING
GLOBAL ECONOMY
Q2/2004

The Customer Becomes the Boss

Former Bank One CFO
Takes the Helm of
JPMorgan's Treasury &
Securities Services

Heidi Miller,
JPMorgan Treasury &
Securities Services
Executive

 JPMorgan

thinking out loud

What an exciting year so far! We've witnessed continued economic growth in the major markets around the world, with signs suggesting that we're in the midst of a sustainable economic recovery. Further, the merger of the JPMorgan Chase and Bank One holding companies became official on July 1st, launching a global financial services franchise, with top-tier positions in the full range of banking services for consumer, corporate and institutional investors worldwide.

In celebration of the merger, we are pleased to introduce Heidi Miller, the new head of Treasury & Securities Services (TSS) in our cover story, "The Customer Becomes the Boss." With the Investor Services' business a core element of the global franchise, Heidi talks about how the power of our newly merged firm will help to provide our clients with a broader platform of products and solutions and an even higher level of service quality.

Also in this issue, for the first time we present, "Thought Spotlight," a special section focusing on issues of particular interest to certain market segments. Our first Spotlight is dedicated to the U.S. pensions, endowments and foundations market. A record 35 million Americans and their families participate in the U.S. corporate pension system. With pension reform currently at the forefront of the U.S. financial and political agenda, we've partnered with JPMorgan Fleming Asset Management's Strategic Investment Advisory Group (SIAG) to present some of the important issues relating to the changes in U.S. pension regulations. This special section also includes "Pensions, Endowments and Foundations Find Growing Appeal in Securities Lending," featuring our Securities Lending and Global and North American Client Management teams, as well as one of our valued clients, sharing their ideas on the growing popularity of securities lending in this market segment.

Other features include, "Change and Opportunity in Beijing," featuring Laurence Bailey, business executive, JPMorgan Investor Services Asia Pacific, on the dynamic changes in Beijing, China, and some of JPMorgan's activities in the region. And also, a timely story, "Step Up and Vote," and an important sidebar, "U.K. Pushes Proxy Voting Reform." In this story our colleagues from Europe, Middle East and Africa review activities with regard to the influential report by Paul Myners, a leading British reform advocate, focusing on proxy voting reform in the U.K. In addition, the piece highlights JPMorgan's Proxy Voting Service and discusses issues relating to the SEC's fast approaching August deadline.

As we enter a new era in financial services your feedback helps us continue to raise the bar on our commitment to you, our clients, to deliver the leadership, expertise and innovation that can help you achieve your most important business objectives. We hope you find *Thought* both enjoyable and informative. Your comments and suggestions for topic and story ideas are always welcome. Contact us at thought.magazine@jpmorgan.com.



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thoughtcontent

COVER STORY

3 Viewpoint: The Customer Become the Boss

An interview with the new head of TSS, Heidi Miller

FEATURES

5 Industry: The Outsourcing Continuum

Paula Sausville-Arthus, Asset Manager Solutions Group executive, on the next phase of Outsourcing

7 Industry: Step Up and Vote

Developments in proxy voting in the U.S. and the U.K.

11 Ideas and Innovation: Tools for Efficiency: There's No Time Like the Present

Tools for corporate actions

12 Professional Profile: John Galante, Chief Technology Officer

Introducing Investor Services new CTO

14 Industry: Fair Valuation

JPMorgan on the forefront of this important industry topic

16 Viewpoint: Change and Opportunity in Beijing

Laurence Bailey, Asia Pacific business executive on the dynamic changes in Beijing, China

THOUGHT SPOTLIGHT

18 Pensions, Endowments and Foundations Find Growing Appeal in Securities Lending

Flexible solutions increase the use of securities lending

22 A Review of Pension Regulatory Changes

JPMorgan Fleming's Strategic Advisory Group (SIAG) reviews changes in the pension environment



the customer becomes the boss

All of this, Miller sums up, “Leads to a more diversified, consistent earnings stream. The result is the kind of stability that shareholders value and that clients like in a provider they plan to have a long-standing relationship with.”

Nothing Beats Experience

Neither firm is a novice to big mergers (most recently, JPMorgan and Chase merged in 2001, and Bank One and First Chicago merged in 1998). So Miller feels that both companies understand what it takes to execute transactions of this magnitude.

Former Bank One CFO **Heidi Miller** takes the helm of TSS



Heidi Miller, who has been called one of the most powerful women in American business, has enjoyed a dynamic and successful career with some of the financial industry's most well known names — holding leadership positions as CFO for Citigroup and as Vice Chairman of Marsh, Inc. In the days just following the official merger of the two industry giants, JPMorgan Chase and Bank One, Miller spoke with *Thought* magazine about the strategic, financial and cultural aspects of the merger and the strengths of TSS.

“I’ve been through many mergers,” she says, “but since the announcement of this deal, we have accomplished more to date than in any other merger I’ve been involved with. We’ve done a huge amount in a relatively short period of time in terms of planning, nominating the appropriate people to manage the businesses, calling on customers, deciding which systems to retain, establishing risk policies, and so on. That gives me great confidence that we’ll be able to fast-forward the execution of our plans.”

Miller states that the number one priority during the merger process is, of course, to impact the customer as little as possible. “We want to execute this merger in a manner that is seamless to our clients.”

Mixing It Up

It is no secret that change can cause concern for some clients. They worry that a firm may become too big, cultures won’t mix, and as a result service quality will suffer.

Miller notes that any differences in the cultures of the heritage institutions are a natural extension of two different business focuses: JPMorgan Chase, which is global and predominantly wholesale, and Bank One, largely retail and U.S.-centric. However, she believes that there are more similarities than differences.

“Bill Harrison (CEO of JPMorgan Chase) and Jamie Dimon (President and COO) bring to the business shared values in terms of what makes a firm a leader in the industry... being responsive to clients and improving productivity and efficiency. They demand the same level of integrity, as well as a commitment to developing governance standards that are clear, and reporting that is transparent.”

In addition, she says, “My observation is that Bill and Jamie are setting a high standard of partnership at the top of the house.” Miller and other senior business leaders have been meeting with them a few times a month.

In one of the largest and most compelling mergers in the history of the financial services industry, JPMorgan Chase and Bank One became one under the JPMorgan Chase name on July 1st. At this significant point in the new firm’s history, Heidi Miller, former Bank One CFO, took the helm of JPMorgan’s Treasury & Securities Services (TSS), its Custody, Cash Management, and Trust businesses.

“You don’t do trillion-dollar mergers like the one between JPMorgan Chase and Bank One if the only benefit you can identify is cost savings,” says Miller. “Sure, the savings provide a cushion to put drivers of the business in place that can give you better value for the client and the shareholder. But the value of cost savings is temporary and static.

“You need to identify longer-term benefits if you want to create a well-capitalized, healthy company in a stronger position for growth,” Miller adds. In the case of JPMorgan Chase and Bank One, she cites among the merger’s benefits: a more balanced business mix between wholesale and retail activities; leading market positions across products, client segments and geographies; scale; and financial strength.

“We have had a lot of consensus about the direction we want to take. Considering that not all merged management teams operate in such a collaborative way, we have had very few disagreements about issues ranging from how we want to organize financially, to what systems we want to use.”

TSS at the Core

As a former CFO of Citigroup, Priceline.com and Bank One, Miller brings a unique perspective to her new role as head of TSS, which counts among its clients CFOs, corporate treasurers and fund managers. “I do still think like a CFO,” she admits. “My first hand experience in that role gives me a distinct view of what these businesses can do. I’ve already started calling on clients with our sales and relationship teams, and I plan to do more of that.”

Citing Investor Services as an example, Miller says, “Our custodial relationships are historically long-term, which is good for us and for our customers. Not only do we generate repeatable earnings; we also cement relationships with customers who are doing or will do business with other areas.”

Heading to Best in Class

Miller’s strategy for the three businesses of TSS is succinct: to be best-in-class. All the TSS businesses benefit from scale in the larger merged company. Scale means greater processing efficiency and provides opportunities to create value for customers — whether by pricing specific products more competitively or reinvesting in product development and leading-edge technologies, “in a way that smaller, less-capitalized providers cannot,” says

As for Investor Services’ existing clients, Miller says, “We know that our competitors keep a close watch on our clients, because we have the best clients in the business. We plan to extend our product offering in areas such as insurance accounting, enabling insurance and mutual fund companies to take advantage of the ongoing trend to outsource selected accounting functions. And we need to invest sufficiently to maintain our position in corporate actions as the most cost-effective processor, with the least amount of risk involved.”

Commitment to the Business

Finally, Miller believes the merger solidifies JPMorgan Chase’s long-standing commitment to serving the needs of the investor community and should dispel

“We want to execute this merger in a manner that is **seamless** to our clients.”

Miller likes the three businesses of TSS — Investor Services, Treasury Services, and Institutional Trust Services — because, “They are core to the JPMorgan Chase franchise and leaders in their respective markets,” she says.

“Investor Services was recently ranked the number-one global custodian — with nearly \$8 trillion in assets under custody — and has a leadership position in securities lending,” explains Miller. “Treasury Services is the leading cash management provider in the world, as well as the leader in U.S. dollar clearing (handling as much as \$2.5 trillion a day), Automated Clearing House, standby letters of credit and controlled disbursement. Institutional Trust Services is among the top businesses in issuer services; the number-one trustee for U.S. corporate debt; the number-one global trustee for U.S. collateralized debt obligations; and number one in American Depositary Receipts (ADRs).”

What’s more, she says, “The great thing about these three businesses is that their transactions are not one-off — they’re multi-year dealings with consistent revenue streams. That’s an important contribution to JPMorgan Chase’s stability.”

Miller. “Technology is at the heart of our businesses, and the new JPMorgan Chase will invest capital in the product, service and technological innovations that are priorities for our clients.”

An important element of the TSS strategy goes beyond processing transactions. In Treasury Services, for instance, “We not only provide clients with the ability to make timely and accurate payments, we give them the tools to make informed decisions about their cash flows, and optimize their working capital and liquidity,” she says. Another key path to best-in-class stature is client care. All three TSS businesses are focusing on strengthening customer service as another way to distinguish them from the competition. “Client satisfaction drives revenue. Accuracy, reliability, timeliness, and follow-through are hallmarks of quality that clients have every right to expect from us.”

The merger also gives TSS businesses such as Investor Services the opportunity to increase market share by offering its products to Bank One’s 20,000 middle-market and 11,000 large corporate customers, most of which do not overlap with JPMorgan Chase’s customer base.

any rumors regarding ongoing support of the Investor Services business. “It would be hard to look at us now and not feel confident that this business is vitally important to our organization,” she says.

“Since the very beginning of the merger both Jamie and Bill have emphasized, and I agree, that the TSS businesses are central to what we are as a firm. If you’re lucky enough to have a number one, two or three position in businesses like these,” Miller explains, “then you want to guard them with your life and nurture their growth.”

Miller echoes Harrison’s and Dimon’s sentiments about TSS when she says that “these businesses represent consistent, annuity-like earnings streams; client relationships that are long-standing and that can be leveraged; and channels of distribution ranging from small businesses and middle market companies to municipalities and governments.”

In other words, “TSS is key to the new JPMorgan Chase’s future. We’re going to be in the game for the long haul, and we’re going to continue to work to keep getting it right.” ○○○

The outsourcing business has moved into a new era, says Paula Sausville-Arthus of JPMorgan Investor Services, but there is still plenty of scope for further development.

the outsourcing continuum

By Paula Sausville-Arthus, Asset Manager Solutions Group executive



After a number of stalled beginnings outsourcing of investment management operations has joined the ranks of mainstream financial services solutions. In the five months prior to March 2004, U.K. and U.S. investment managers closed on deals accounting for \$300 billion in assets, a 200% increase over the entire year 2002. Major international investors — including ISIS Asset Management, Morley Fund Management, AXA Investment Managers, Standard Life Investments and Investec Asset Management — have already signed outsourcing agreements, while many others are close to concluding deals. We saw outsourcing finally leave the drawing board and go into production.

To be fair, there have been isolated outbreaks of outsourcing since the early nineties, but these have been the exception rather than the rule. Furthermore, the recent enthusiasm for outsourcing is predominantly a European phenomenon, with few significant U.S. mandates to report. But we are beginning to see an irreversible transition from the era of custody to the era of accounting and administration.

That transition is all part of the continuum of outsourcing. The custody industry has grown from its original remit as a provider of core securities movement and control functions to a pivotal partnership role as a global investment administrator. Fund managers no longer come to us to talk about global custody: they come to us to seek out solutions to complex investment structures and strategies. Thoughtful investors are not looking for products; they are looking for answers, and they are asking us to partner with them to meet those challenges.

Delivering the Firm

Over the 30-year history of the global custody business we have earned that confidence by improving and expanding our services and delivering on our prom-

ises. We are no longer treated as low value vendors: today, our most important client relationships are more properly viewed as true partnerships.

With every new outsourcing arrangement, we have to prove ourselves. We have to execute to the client's specification and deliver the benefits that they have a right to expect. At the same time, we have to move along the outsourcing continuum, refining the service and incorporating best practices as defined by our clients' changing requirements. Driven primarily by technology, the pace of change over the past five years far exceeds anything we have previously experienced, challenging us to compress product development cycles and accelerate implementation schedules.

As a result, we no longer operate as a stand alone business unit. Twenty years ago, the global custody divisions of most major banks would probably have links to the Treasury dealing room and the cash management department. That was the extent of cross-selling, and the limit of client expectations. But, as clients demanded more, custodians looked increasingly towards other units of their firm to deliver a broader spectrum of

services. From securities lending and collateral reinvestment through to tax management, performance analysis and commission recapture, for example, clients have steadily devolved more and more of their non-core operations to their custodians.

An Infinite Challenge

The question most frequently asked about this trend is, where does it all end? To us, the answer is straightforward: it never does. We do not see outsourcing as having a finite life cycle. Three years ago, for example, administration of alternative investment funds was a relatively underdeveloped, specialist activity; today, it has become a core element of global investment servicing. We need to follow and, where possible, anticipate investment trends so that we are ready to meet new client challenges.

To make this work, and to strengthen client relationships, requires a major investment of intellectual capital. This is where we can draw on the expertise of our colleagues in other areas of the firm, developing solutions that go far beyond traditional asset servicing capabilities. Our experience suggests that, beyond what we might consider to be mainstream outsourcing, the most advanced clients are already pursuing two further routes: data management and front-office services.

Data Management

A growing number of buy-side firms have accepted that data management is not a core part of their business, and they are actively seeking ways to outsource the function, while still retaining ownership. From an investment administration perspective, it is rare for an asset manager to have a single-source relationship, so effective data aggregation, manipulation and delivery becomes vitally important, as well as being labor-intensive.

Custodians have always been in the business of data management: when you run a network of 80 agent bank relationships around the world, you soon learn about the values of standardization and common protocols! As a result, managers are asking us to develop toolkits that enable them to manage their data more effectively or they are seeking to outsource the entire data management function to us, leveraging off our advanced information delivery tools.

One of the key drivers behind this move is the need for greater operational efficiency: straight-through processing. Under severe cost pressure, few managers are willing to spend substantial sums of money in straight-through processing when they are uncertain of an acceptable return on investment, yet they recognize the cost and risk benefits. Custodians can bridge that gap: JPMorgan Investor Services, for example, has recently launched a message management service that provides links to industry messaging utilities without the technology costs associated with the multiple and changing requirements of industry and counterparty standards. The service includes a Swift service bureau, providing outsourced Swift connectivity, facilities management, disaster recovery and data processing services.

Front-Office Services

Although investment operations outsourcing can make a significant impact on a manager's bottom line, there is no escaping from the fact that some 80% of fund management costs are incurred in the front office. As well as a need to reduce these costs, managers are also being driven by heightened regulatory scrutiny to look closely at how the money is spent.

Analysis of total transaction costs, including portfolio transitions, has become one of the highest priorities for managers and

their clients as they look for savings and regulatory compliance. Several custodians have successfully moved into the transaction cost analysis space, buying or building services that provide customized data on the real cost of doing business. This can be used by pension funds to benchmark their managers, but the managers themselves are also keen to ensure that they remain competitive and that they can produce independent verification of their cost-effectiveness.

Following the well-publicized issues last year concerning the validity and independence of investment banks' research, managers are also evaluating alternative sources of research. Some custodians are delivering aggregated data from independent providers, while others are generating investment flow information from their own database. JPMorgan Investor Services has an investment



research evaluation service which assesses the value of research to the investment process.

The industry is slowly edging towards a greater acceptance of custodians in the trade management and execution process, especially for market-size trades in liquid stocks where there is little value to be added by the counterparty, and for retail trades that are labor-intensive. Consolidating trade execution, processing and settlement with one provider has enormous benefits in terms of operational cost and efficiency, and some managers have already started to use custodians for a portion of their trade execution.

Flexibility is Key

As we begin to implement the latest wave of outsourcing mandates, it is clear that we are only scratching the surface of what can be achieved if we can manage our client relationships effectively and deliver on time and to specification. Clearly, one of our early objectives as an industry is to develop standardized business protocols so that transitions are more straightforward to manage and expectations on both sides of the partnership are easier to achieve. We envisage the establishment of client user groups to develop these protocols as more outsourcing mandates are awarded.

We also need to build in flexibility, because we know only too well that one size will not fit all. While U.K. fund managers have enthusiastically embraced total outsourcing, the U.S. market is quite different. There, U.S. managers have historically followed a component-based approach to outsourcing, devolving functions such as transfer agency and fund accounting to different providers on a segregated basis. Over time, some of these relationships may be consolidated, but there are also major opportunities to deliver data collation and aggregation services. Custodians have to be alert to these differing needs and adapt according to local market preferences.

Thirty years ago, a far-sighted institutional investor, the Ford Foundation of the U.S., asked its banker, Chase, to come up with a solution to the problem of administering foreign investments. The bank rose to the challenge and the global custody concept was born. What is happening today is no different: asset managers are relentlessly streamlining their operations to give them a competitive edge, and they are asking their custodians for the tools they need to achieve their goals. ○○○

For more information on outsourcing, contact Paula Sausville-Arthus at (718) 242-5310 or email her at paula.sausville-arthus@jpmorgan.com

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Corporate Governance: **step up** and



Be ready for the *august* deadline

“Few among us would dispute that publicly held companies are the lifeblood of our economic and financial systems, or that as practitioners in the securities industry we have a considerable stake, not only in the continued success of these businesses, but also in earning the faith of both investors and beneficiaries,” says Ted Rothschild, JPMorgan Investor Services Custody Product Management specialist.

Yet, recent corporate scandals have left shareholders disillusioned and the accountability of corporate boards has become a hot button issue — with the role of shareholder voting rights under the spotlight. “The power to vote on corporate issues is one of the most fundamental ownership rights held by shareholders of a corporation,” says Ed Neeck, Network and Securities Processing Product Management executive, JPMorgan Investor Services.

With proxy voting becoming more and more scrutinized by public interest groups, and greater disclosure among the most active demands of shareholders, the use of electronic proxy services (see also sidebar “Tools for Good Corporate Governance,” p. 8) is rapidly increasing to ensure that voters have fast and efficient access to voting at annual meetings.

“Increased scrutiny within the investment community, from both regulators and special interest groups, has resulted in strong pressure on investment managers to ensure that they vote all meetings and publicize their votes,” says Rothschild. The first annual report on such activities is due from Investment Managers to the Securities and Exchange Commission (SEC) on August 31, of this year, when voting records will be made available to the general public. All funds must publish their voting record for the period of July 3, 2003 to July 3, 2004.



tools for good corporate governance

JPMorgan's Proxy Voting Service

Corporate governance and proxy voting have never been more important or more closely examined than today. To support investment managers in complying with the new SEC proxy disclosure rules, JPMorgan's Proxy Voting Service offers a powerful new solution for the institutional investor. JPMorgan's Proxy Voting Service provides full online electronic voting capabilities that help institutional investors exercise their proxies and fulfill their increasingly expanding corporate governance responsibilities.

Together with Institutional Shareholder Services (ISS), JPMorgan's Proxy Voting Service offers clients access to the substantial breadth and depth of proxy voting expertise of both firms. It not only allows institutional investors the ability to execute a vote, but also to execute that vote with intelligence and precision.

JPMorgan's Proxy Voting Service delivers information on shareholder meeting notifications and resolution agendas through ISS's VoteX™ platform. Powerful user features and emphasis on timeliness of information delivery and market context, all allow for informed monitoring of workload and meeting agenda content.

Immediately upon receipt of meeting notifications, JPMorgan's Proxy Voting Service forwards the information to all enrolled clients with relevant holdings, online, real time through VoteX™ via SWIFT or fax. JPMorgan actively provides resolution agenda and relevant meeting information for any scheduled shareholder meetings in over 60 markets including: meeting date, type of meeting, agenda of resolutions, voting entitlement, notice of blocking requirement, and date by which voting instructions must be returned. In addition, original meeting agenda's are accessible online via VoteX™ with hyperlinks to available company Web sites for access to financial statements.

Using straight-through processing JPMorgan receives a client's vote instructions via VoteX™ and instructs local market sub custodians via the SWIFT network and ISO 15022 messaging standards. For clients with U.K. holdings, JPMorgan will leverage ISS's automated interface with the CRESTco's U.K. electronic voting system.

In addition to core proxy services, JPMorgan offers clients access to third party vendors who can assist with establishing proxy voting guidelines, analyzing the implications of proxy items and identifying specific actions on proxy items.

Good corporate governance is not an option but rather the responsibility of all market participants. The fiduciary importance and financial benefits of successfully and properly voting proxies is paramount in exercising shareholder rights. With 24/7 customer service, JPMorgan Proxy Voting Service proactively serves the needs of institutional investors with a high quality cost effective proxy voting solution.

That scrutiny is evidenced in a recent *BusinessWeek* article, “Higher Ed: Rocking the Proxy Vote.” The story features Williams College senior Mark Orlowski, who was awarded a grant to research how universities vote proxies on the stocks they own. His research revealed that most don’t. Orlowski and his colleagues formed Responsible Endowments Coalition (for information see www.sriendowment.org) which helps interested parties organize to encourage schools to invest their endowments in line with university values, in short, to fulfill their fiduciary obligation. “The way investors can influence a company’s corporate governance activity is through proxy voting,”

Neeck explains. “Heightened awareness of proxy voting is an important trend in the industry, it’s a way for investors to influence change.”

However, the looming deadline and the media obsession with market practices and quirks in the global proxy voting process contain the ingredients for error and confusion. “It is the custodians’ responsibility to help clients understand the process, its inherent weaknesses, and to identify whether a particular issue is within or beyond the control of the voter and/or the chain of agents that support the owner/voter,” says Rothschild.

Disclosure rules are about the action your firm has taken, not the action that took place at the company.

The following questions may be used to evaluate your position or to form the basis for further discussion:

What is the investment manager’s responsibility?

U.S. regulation requires that U.S. investment managers publicize their voting policies and voting records for any public fund, with data collected from July 2003 to July 2004, to be filed by August 3, 2004.

Although managers are required to disclose their record of voting as well as their general policies, they are not required to demonstrate that any individual company accurately processed the vote.

The fund and/or its investment managers *are not and cannot* be held accountable for the actions of a company in which it invests with regard to that company’s procedures regarding proxy votes.

What is the definition of “disclosure” as it pertains to the manager’s responsibilities?

It means your disclosure of your firm’s policy as to how you approach deciding how to vote on particular issues and follow-through on your position. However, it doesn’t mean that you are responsible for what the issuing company does or doesn’t do with the voting results.

If, for a variety of reasons, your vote may not have been counted — keep in mind that disclosure rules are about the action YOUR FIRM has taken, not the action that took place at the company. Just be sure to use a custodian who follows the appropriate procedures to submit your vote — because the voting is important above and beyond your policy and intention.

What is the responsibility of the global custodian to influence market practice?

Leading global custodians can lobby both directly and indirectly to influence foreign market practice and legislation. They can leverage their sub-custodian network to participate directly in negotiations with local authorities. In France, for example, network management representatives were repeatedly invited to discuss and comment on pending legislation that ultimately led to the end of “wet” signature requirements and lengthy blocking periods.

In the U.K. JPMorgan and other global custodians actively participate in the CRESTCo efforts to create a better process for foreign institutional investors, leveraging its capability as Central Securities Depository to impact the process. In 2004, CRESTCo will facilitate our ability to deliver investor’s votes with the introduction of a groundbreaking facility to assign reference numbers signifying registrar’s acceptance of votes.

Through efforts such as these, and by participating in industry initiatives like the International Corporate Governance Network¹, founded to bridge the gap between corporate management and shareholders, global custodians can work to create more standard procedures and practices in all the significant capital markets.

In summary, JPMorgan Investor Services’ goal is to support responsible corporate governance by facilitating the procedures that recognize the investors’ right to vote, anywhere in the world. ○○○

For more information contact your relationship manager or client service officer.

1. Founded by prominent institutional investors in the U.S. and U.K., including CalPERS, TIAA-CREF, the Association of British Insurers, the Cadbury-Hampel Committee on Corporate Governance and the National Association of Pension Funds in the U.K.



In response to high profile cases of “lost votes” in the U.K. market, Paul Myners, a leading British reform advocate, was commissioned by the U.K. Shareholder Voting Working Group to perform a detailed review of the voting process. His influential 44-page report, *A Review of the Impediments to Voting U.K. Shares*, was published earlier this year with far reaching recommendations to all participants in the area of corporate governance.

uk pushes proxy voting reform *A Review of the Impediments to Voting U.K. Shares*

JPMorgan was an active participant in the review and supports the findings and recommendations. “By bringing together all of the participants involved in the voting chain, from issuers through to custodians, beneficial owners, fund managers and vote agencies, Myners quickly brought to light the problematic areas involved in the current manually intensive vote execution process,” says Sheila Somerville-Ford, Custody Product Management specialist, JPMorgan Investor Services EMEA. “It was encouraging, but not surprising, to find that all parties were in agreement that there is an opportunity as well as a genuine willingness to improve much of the process by way of a ‘best practice approach’, rather than through legislative reform,” she says. “It is encouraging that the recommendations are being reviewed for their applicability in other international markets, such as Australia, to drive best market practices.”

“With the 2004 proxy season underway,” says Somerville-Ford, “we’ve already seen evidence that the recommendations put forward by Myners are being adopted. “So far,” she explains, “there is evidence of a 67% increase of issuers that have introduced electronic voting capabilities for the first time this season.”

The Myners report highlights the need for reform within the industry to allow a greater audit trail of vote instructions and increased transparency between issuers and beneficial owners. The report has received full backing from key industry associations including the National Association of Pension Funds, the Association of British Insurers and is being considered by the Minister of Trade and Industry to reform company law.

Recommendations include:

Registering Title to Shares

Beneficial owners and investment managers should consider designating their shareholdings and custodians should support such requests where possible.

Electronic Voting

All participants to embrace electronic voting in 2004.

Voting Policy

Beneficial owners should determine and implement a voting policy. Investment managers should actively exercise their votes and publicly disclose voting policies.

Stock Lending

Shares should be recalled by owners for contentious meetings.

Deadlines

Amend the 48-hour rule for voting to close of business, two business days prior to the meeting.

Proxy Power

More rights should be given to proxies to speak and vote on a show of hands at meetings.

Results Disclosure

FSA to make a listing requirement for companies to disclose meeting results on websites and annual reports.

To get a copy of the Myners report, *A Review of the Impediments to Voting U.K. Shares*, or to read JPMorgan’s *Investor Services Response Paper*, visit jpmorgan.com/investorservices and see our Industry Initiatives and Commentaries section or contact your relationship manager or client service officer.

According to a recent Oxera study sponsored by The Depository Trust and Clearing Corporation (DTCC), close to one million corporate actions take place worldwide each year*. The study says, "A single event may involve hundreds of different market participants," including fund managers, broker-dealers, depositories and global custodians, and "ultimately cascading down to thousands of investors. Each of these participants faces high risk because corporate action processing is complicated, deadline driven, not standardized and to a large extent still manual."

In response to this environment JPMorgan Investor Services is offering clients a number of products, services and efficiency improvements to help eliminate some of the difficulty and risk associated with processing corporate actions.

tools

tools for efficiency: there's no time like the present

Corporate Action Instructions Online

Processing corporate actions accurately and promptly has historically been an industry challenge due to the manual processes involved. For custody clients seeking to manage their portfolios more efficiently and effectively, JPMorgan's Corporate Action Instructions Online provides a user-friendly, Internet-based way to respond to corporate action

information online. Corporate Action Instructions Online — accessible via JPMorgan ACCESSSM — helps clients reduce risk and improve operational efficiency by replacing phone- and fax-based systems.

This innovative corporate action tracking tool features:

- Delivery of corporate action notifications

- Internet access using single sign on and state-of-the-art security safeguards
- Easy inquiry via its "fast search" function
- Ability to overwrite/amend pre-populated instruction data
- Ability to bulk instruct/respond
- Robust online instruction audit trails
- Red/amber/green deadline management

Online Corporate Event Prospectus Information

Prospectuses — which can run upwards of 100 pages and take three to four days to arrive by mail — contain vital information to help clients make important decisions regarding a corporate action event such as a tender or rights offering. Perusing the long and difficult to navigate hard copy document can be time consuming.

Later this year JPMorgan Investor Services will be the first global custodian to introduce a new service that eliminates the bulky documents associated with corporate action events and puts that same valuable prospectus information online in an easy to navigate digitized format.

When a corporate action occurs, clients will receive an email with a link that will take them to a digitized online prospectus. Not only can the document be shared with the appropriate parties internally, the digitized format allows users to quickly navigate the prospectus and review areas of interest. Through key word searches, users reduce time and effort, streamlining the corporate actions process.

Automating DTC Responses

In JPMorgan's continuing effort to reduce the risk associated with global investment transactions, Investor Services' United States Securities Operations (USSO) group is working closely with The Depository Trust Company (DTC) to be the first in the marketplace to execute automated client instructions to DTC.

Later this year, instructions from clients who use JPMorgan's Corporate Action Instructions Online product will benefit from their files automatically being sent directly via the corporate actions system to DTC.

"It's a great efficiency improvement that reduces risk on both sides," says Brian Goldman, USSO business manager. "While clients won't likely notice any difference, it certainly improves the accuracy with which we communicate their instructions to DTC." ○○○

* This does not include the 3m plus scheduled fixed-rate payments and scheduled maturities that occur every year.

For more information about these or any of JPMIS products and services, contact your relationship manager or client service officer.

Introducing Investor Services' New CTO

john galante



Earlier this year, John Galante joined JPMorgan Investor Services (JPMIS) as Chief Technology Officer. Responsible for the day-to-day leadership in technology for JPMIS on a world-wide basis, he brings a wealth of experience to the position.

His career includes an impressive array of technology positions in areas including clearing, settlement, asset servicing and accounting with some of the world's biggest global companies. Recently, Galante sat down with *Thought* magazine to discuss his plans for the JPMIS Technology organization, his ideas on global financial services in general, and his thoughts for the future.

Thought Magazine: Your career has included a number of important areas of the business, what are some of the major technological changes you've seen during your career?

John Galante: Well, we've seen a wave of movement away from a mainframe, batch processing orientation to a distributed online orientation. Today the question is how do we web-enable applications, and how do we get the core processing to be more cost effective? What happened in the transition from mainframe to distributed processing is that much more of the control moved to the user communities. The number of platforms and applications has proliferated, and while the functionality improved in terms of decision support and processing, from a technological perspective the costs have increased dramatically. Along with the drive toward Web enablement, there has also been an increased emphasis on more timely access to accurate information and a focus on consolidation and more efficient core processing.

You mentioned "efficient delivery of core processing," is that your primary focus now at JPMorgan?

That's part of it. I feel very fortunate to have inherited an organization filled with so much talent, people with deep technical and business experience. Our work will focus on creating ways to leverage the skill of those talented people and instill best practices in terms of project delivery. The organization had become somewhat decentralized from a technology standpoint. As a result, currently there are multiple client facing applica-

tions and technological components. Now what we have to do is bring that back together in the form of a simple streamlined architecture, and standards in terms of the way we do things, the systems lifecycle we follow and the way we communicate with our customers.

JPMorgan is the most customer-focused organiza-

tion I've ever seen, the best of any situation I've been in. Now we need to take that customer focus, the servicing of our customers, and work to align the technology in a way that's more efficient both internally and for our clients.

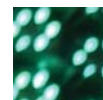
Providing customers with the products and services they need?

Right. It's giving customers what they need, but also doing it in a more simple way. As I said before, right now we've got multiple customer-facing applications, that we're working on standardizing and maintaining a best-in-breed approach. On the one hand we have our great culture of customer focus and then on the other hand we have the question of optimal design delivery and how we provide technology in the most efficient way.

For example, since I arrived here one of the things we've focused on is reducing our internal costs. Consultant fees is one example. We've driven that cost down dramatically by reducing the number of consultants and renegotiating rates and contracts. Now we have a model that recognizes the value of business and technology subject matter expertise and weighs more heavily toward internal resources. That's just one of the ways we've already dramatically improved efficiency and worked to leverage that in-house talent that I mentioned before.

Are there two or three areas in particular where you are focusing your efforts?

As I said before we're concentrating on reducing our internal costs overall and dramatically improving our ability to deliver projects in a timely, cost effective way.



“JPMorgan is **the most customer-focused organization** I’ve ever seen.”

In addition, we’re working at establishing clear business driven accountability for the Technology team. We’ve realigned the organization to directly support Investor Services businesses. In the past, the organization was split between production support and development, but there was no clear accountability to the individual businesses themselves. Consider technology for our Accounting team. Now we’ve combined the organization in such a way that each of our locations around the world, Dallas, Bournemouth, New York, etc., has someone dedicated to focusing on Accounting technology and that effort is coordinated by one global Technology team executive for the Accounting group. This structure ensures that there is a global strategy and consistency around the world no matter what the project. We’re focused on clear accountability every step of the way for people, projects and applications.

That’s what I keep reinforcing with my management team. Who and what do they manage? They manage people, they manage projects and they manage applications. Their job is to make sure people are motivated and developing everyday, they have to make sure projects are being developed on time and on budget throughout the lifecycle and they have to manage the applications in a way to make sure they can absorb additional business and volume. That is simplifying it in a way, but essentially that’s how I frame it.

What do you see in the future for the JPMIS Technology organization?

I think Investor Services will continue to see more growth in terms of the types of products and services that our customers want us to provide and I think that will take two forms. First, it will take the form of existing activities that customers will decide they no longer want to do themselves and will want us to do, that’s middle office processing, technology support, etc.

The second form is the amount of information that our customers will increasingly demand to make their day-to-day decisions. They will focus more and more

on things like cost of execution and costs per transaction. I also think there will be a growing focus on regulatory compliance information, order management, trade management and an ability to provide MIS to support that. This will help customers to ensure audit trails and know that they are properly managing their portfolios. That’s something we’re beginning to provide more of now and an area where I think we have a tremendous growth opportunity in the future.

We’re currently investing heavily in a new state-of-the-art information delivery solution that will add significant value to our clients with critical information and reporting provided in an intuitive and flexible way. The product also includes a new performance measurement system that offers customers advanced technology and capabilities. There’s nothing like it in the industry, We’ve shown it to a few clients and the feedback has been very positive, so everyone should stay tuned to hear more about that.

Finally, how do you think the merger between JPMorgan and Bank One will impact the Technology team?

It brings another dimension and thought process to how we manage technology. Suddenly, we now have an entire set of additional resources in terms of technology, whether it be infrastructure, applications development or leading edge services. Like Investor Services, Bank One brings some very talented folks to the new organization. I can see an immediate impact from their wealth of experience in managing technology in terms of creating a more efficient infrastructure. For example, working to leverage vendors appropriately across the new combined organization. JPMorgan and Bank One are very complementary, whether we leverage one another’s relationships or products, there is very little overlap from a JPMIS perspective. I think from both the Technology organization and the overall business’s perspective the merger presents a tremendous opportunity. ○○○

To learn more about JPMorgan Investor Services’ Technology organization contact John Galante at (718) 242-3367 or email him at john.m.galante@jpmorgan.com



The Securities and Exchange Commission (SEC) has stepped up its scrutiny in recent years of mutual fund share valuation practices in an effort to curb potential trading abuses. Here's what JPMorgan Investor Services has been doing all along to cut the problem off at the pass.

Approximately two years ago, the SEC significantly stepped up its scrutiny of daily mutual fund valuation and the issue is now making headlines for all investors to see. The SEC's focus: to eliminate much of the incentive for market timing, which, although not illegal, can give rise to trading abuses that can impact returns for the long-term mutual fund investor. As a result, the SEC has placed a greater burden on fund administrators to come

The crux of the SEC's position rests on the fact that when short-term investors — i.e., market timers — attempt to exploit the scenario where the values of stale-priced securities in a fund are likely to have changed significantly by the time a fund uses it to calculate the net asset value. Sufficient knowledge of a fund's portfolio composition combined with an understanding of the movement of securities market prices and values give the market timers the opportunity to arbitrage the fund net asset values from day to day. This potentially harms long-term shareholders due to the erosion of earnings and capture of profits by short-term investors. It may force funds to manage a portfolio in a disadvantageous manner, whether through liquidating securities to accommodate market timers or maintaining a larger percentage of portfolio assets in cash to meet higher redemption levels.

The Solution: Fair Valuation

While there are actually a few options available to mutual funds to combat market timers, fair value pricing of mutual funds, typically executed through an automated process, is gaining in popularity as an effective solution.

fair valuation: jpmorgan at the forefront

up with ways to fairly value shares and ultimately, discourage trading abuses in order to safeguard long-term shareholder interests.

The Pricing Problem

The need for fair valuation of mutual fund portfolio securities has its roots in two fundamental issues: "cutoff" times for calculation of net asset values and market timing activities.

For the pricing of most U.S. domestic securities, the typical fund's late-afternoon cutoff — a 4 p.m. EST deadline for the U.S. — poses no problem. Fund companies simply value their portfolios using the last traded price of the day. Data and pricing services provide a stream of closing prices, which are then applied against the fund's holdings to calculate the value of the portfolio.

In contrast, this issue significantly impacts the many foreign securities held by U.S. mutual funds. Asian markets may close 12 to 15 hours earlier than a fund's valuation time. European markets may close up to six hours earlier. As a result, such prices are often "stale" by the time a fund's net asset value is calculated. While this has never been a secret, unfortunately an increase in market-timing activities aiming to exploit these "stale" prices has given rise to a full-blown SEC inquiry over recent months. Some would even say a crackdown.

Fair valuation, simply defined, is the process of assessing the price of a security that would prevail in a liquid market, assuming all significant market events were adequately "factored into" the security's value. Put another way, fair value pricing, as a rule, assigns estimates for securities that lack readily available market quotations or for later valuation of securities traded in foreign markets long after their markets have closed. Fair valuation processes are often used when market events occur after the local market close, but before a fund's daily net-asset-value calculation. While it is not an exact science, there is no doubt among leaders in the investment community that this act of vigilance is necessary to help prevent abuses and protect long-term shareholder interests.

The JPMorgan Response: Ahead of the Curve

JPMorgan Investor Services was concerned about the issues of fair valuation and market timing before they began making headlines. "We are concerned about the impact the potential disparity in prices for foreign stocks held in our U.S. portfolios can have on the bulk of our long-term shareholders," says Cynthia Davies, senior manager Fund Accounting, JPMorgan Investor Services. "We are strongly committed to taking whatever measures are necessary to prevent the abuses — however rare — that can arise from this price differential due to operating in different time zones."

The fact is, JPMorgan Investor Services put several preventative measures in place in 2001. “As challenges, particularly in the international arena, grow more complex, our work with clients has become increasingly consultative,” says Virginia Meany, Funds Services Western Hemisphere business executive, JPMorgan Investor Services. “Together we have developed customized solutions to address the need for valuations that accurately reflect market realities, especially in certain emerging markets.”

First and foremost, JPMorgan Investor Services took the initiative to engage the services of a third-party pricing source, such as FT Interactive Data and ITG, to provide fair market values for non-North American equities after the close of the U.S. markets. This is a move regarded by many regulators as an added safeguard that helps ensure independent and more comprehensive oversight of the process. Both firms utilize a fair valuation methodology that operates at the individual security level.

Investor Services also elects an automated approach, which is generally regarded as more efficient and certainly more cost- and time-effective.”

The process is driven by a series of “triggers,” approved by fund managers, that alert the fund administrator and the pricing vendor that the fair valuation methodology must be used. (An example of a trigger would include if a certain stock market index, for example the S&P 500 or the Russell 1000, changed by a certain percentage, this would represent a major move in the financial markets, and therefore qualify as a trigger.) Once a trigger is hit — and the list of possible triggers can be extensive, factoring in a number of possibilities in the marketplace — all of the security level fair valued prices that are provided by the vendor are then applied to those earmarked securities. In terms of volume, Davies estimates that roughly 60–80 % of JPMorgan Investor Services’ portfolios are potentially affected.

According to Paul Shield, product manager, JPMorgan Investor Services, “It’s one thing to select a vendor and apply fair valued prices to a portfolio but there is so much more to the issue. An administrator needs to also set up a monitoring and communication process that facilitates timely decision making by fund managers to ensure the interests of fund shareholders are represented.”

“As challenges... grow more complex, our work with clients has become increasingly consultative.”

“Our experience has enabled us to work with vendors as well as fund managers in constructing solutions that best protect the interests of shareholders,” Meany says. “The ‘after the close’ analysis is of particular value to clients. It allows fund managers to compare the fair valued price with the market price. Having the expertise to perform the comparison and analyze the results has added value to the information we provide,” she says.

“This Fair Value Model, introduced a more radical method than many other fund companies from the start in that it pursued a bottom-up approach to fair valuation,” said Russell Warren, director of Fund Accounting and Administration, JPMorgan Investor Services. “For example, fair value pricing essentially assigns an estimate for international equities that lack readily available market quotations. Many firms then utilized — and still do — a process that would fair value the *entire portfolio*, as a whole entity,” explains Warren, “whereby fund leadership would view the events of the day and decide whether market events were significant enough to warrant fair valuation. If so, they would assign what they believed to be a fair value price to a portfolio of securities.”

“Conversely,” notes Warren, “the JPMorgan methodology elected and still uses bottom-up valuation, a method that allows the client to derive fair values for its portfolios by adjusting the individual prices of securities in a fund, instead of the portfolio as a whole. Because of the volume of securities potentially affected, JPMorgan

Fair Value Pricing: Is it Worth the Effort?

The logical question many investors might have is — how effective is fair value pricing? Or even more basic, can its effectiveness be measured at all? Warren responds with a resounding, “Yes. One of the regular checkpoints we employ to test the efficiency of a fair value process,” he says, “is to see whether the next day’s opening prices move in the same or opposite direction as the fair value adjustments.” Shield agrees, “Often, when the market is active or there’s a significant event or shift in the market,” he says, “you’ll see the fair value price is directionally closer to the opening price. This ‘test,’ if you will, has proven that the model we’ve selected and process we employ is, in fact, effective in reducing market timing.”

Overall, the commitment to ensuring that a sound fair valuation process is in place is evidenced by JPMorgan Investor Services’ long-term actions. “We offer clients more than just data,” Meany explains, “we offer the intelligence gained from years of experience dealing with markets, pricing practices and vendors.” Davies adds, “It’s important to our customers and their shareholders that we try to assist funds in discouraging market timers. Market timing activity can increase portfolio turnover and transaction costs for the fund, which directly impacts long-term investors. For that reason alone, we’re prepared to do whatever it takes to help funds continue the fight. Fair valuation pricing is a key weapon.” ○○○

change and opportunity in BEIJING

“The city of Beijing has become a different place,” says Laurence Bailey, business executive of JPMorgan Investor Services Asia Pacific region. His observations are confirmed by visitors who remark that, compared to just 10 years ago, the city of Beijing would be almost unrecognizable to a returning visitor today. Beijing has undergone a transformation into a modern city now characterized by wide boulevards, new hotels, restaurants and modern shops selling designer clothes. This change has not only meant an increase in Beijing’s tourism but has also spawned an increase in the level of foreign interest and investment.



According to www.cbsmarketwatch.com Beijing reported a 9.7% increase in its economy in the first quarter of 2004. “With 1.3 billion people in China, many thought the speed of change would be much slower,” Bailey says. “But where the trend in the last few years had been toward investing into China, the trend now is shifting toward Chinese investors who want to invest their own funds cross border,” reflecting a growing affluence among Beijing’s middle class.

Traditionally owners of all aspects of the financial chain, Chinese banks have started using the services of western banks and global custodians for custody, accounting, performance and securities lending. While the statistics are difficult to justify, as there are no published tables/records to date, Bailey believes JPMorgan Investor Services is one of the largest global custodians in China at the moment. “The local Chinese banks used to only invest through Euroclear, but they’ve started broadening their relationships with global custodians as the services they require increase. Investor Services is well positioned to support these banks as well as insurance companies that are likely to start investing overseas in the near future,” he says.

Proceed with Caution, Phenomenal Growth Ahead

With all the positive developments in China’s market, Bailey does express some caution regarding the highly competitive environment in the country right now. “The challenge,” he says, “is to understand that the financial dynamics of Asia are very different when compared to western ways. In the west, business is focused on quarterly profitability. My fear is that expectations for quick profits have resulted in an influx of investors into the country, many of whom lack the understanding of how the Asian markets work. This could cause companies to become disenchanted quickly when those immediate profits don’t materialize.”

“We can’t let standards and controls fall by the wayside in deference to winning new business. In other words, we can’t let the western way of traditionally doing business distract us if we don’t see an immediate return,” he says. “While we’re all keen to get the next deal,” Bailey explains, “people have to be realistic about what that entails.”

“Not many companies are brave enough to invest large amounts of capital and ride out the uncertainty of ROI. It’s a really interesting situation,” he says.

In addition to the highly competitive environment, the topic of Renminbi (RMB), China’s legal tender (see sidebar p. 17), appreciation and its impact on the world economy have been dominating economic headlines. With more and more multinational enterprises and financial institutions wanting to do business with China, it is the RMB exchange rate, as well as its offshore clearing capacity that is attracting attention. Last November, China’s central bank announced its plan to allow banks in Hong Kong to offer limited offshore RMB services, which has been perceived as a symbolic reflection of RMB stepping towards an international currency, all indicating a direction and a determination on deregulation by the Chinese government.

On a recent visit, Bailey made a presentation to the China Risk Forum, a unique open forum of nearly 80 representatives from China’s banks, fund management and insurance companies. The Forum focused on the topic of risk and featured presentations by Investor Services settlement risk and DVP, as well as its sister Treasury & Securities Services (TSS) business, Treasury Services, talking about operational risk and its Horizon product. In addition, the JPMorganFleming Asset Management team reviewed the market investment risks associated with the process of investing. “The Forum was very well received,” Bailey says. “The Chinese are very anxious to further understand and learn all there is to know about global investing. They attend seminars; they send their people around the world to take in as much information as possible. As a result they are developing a new wave of investments and products.”

Putting Down Roots

China opened its A-share market to foreign institutional investors in 2003, when it introduced the Qualified Foreign Institutional Investors (QFII) scheme. The scheme permits select foreign investors to buy yuan-denominated securities previously reserved for Chinese nationals. To date, China has granted QFII status to 15* overseas investors. JPMorgan attained QFII approval in November of last year, which allows the firm to tap into the debt and the \$500 billion RMB-denominated main stock markets in China.

Several of JPMorgan's team's already have a presence in China. The firm has three JPMorgan Chase bank branches in Beijing, Tianjian and Shanghai. It's sister TSS businesses, Treasury Services and Institutional Trust Services, have representation in the Beijing branch. Investor Services currently services Beijing from its Hong Kong office but is investigating putting down its

own stake there. After a recent visit to China, Tom Swayne, Investor Services business executive said, "I am particularly excited about our growing market opportunities in China. With a few people on the ground our opportunities are even more appealing."

Bailey describes Beijing's atmosphere as dynamic. "When you're there, the city exudes a sense of change and opportunity. Of all the countries in Asia, I think China is really on a mission." ○○○

For more information, contact Laurence Bailey, business executive, JPMorgan Investor Services Asia Pacific, (61-2) 9250-4833 or Steven McCullough, business executive, JPMorgan Investor Services Asia, (852) 2800-1800

* As of May 13, 2004 source: www.chinaeconomicreview.com

facts about beijing

Beijing is the capital of the People's Republic of China. It is the nation's political, economic, cultural and educational center as well the most important center in China for international trade and communications. Beijing will be the site of the 2008 Olympics.

Population

13.82 million

Currency

The Chinese legal tender is Renminbi, or RMB, meaning "people's money." The basic unit of RMB is yuan. 1 yuan is equal to 10 jiao, and 1 jiao is equal to 10 fen. Yuan and jiao are issued mostly in notes. There are 1 yuan,

5 jiao, 2 jiao and 1 jiao coins, and 1 fen notes and coins.

Geography

Located in the north of the Huabei (North China) Plain in the North Temperate Zone.

Longitude: Between 115° 25' and 117° 30' East

Latitude: Between 39° 28' and 41° 05' North

Natural Resources

Beijing has a diversified physiognomy with plains, mountains and hills. The large areas of rocky mountains and the unfavorable quality of soil and inadequate water

supply limit the utilization of land. At least 67 kinds of mineral resources have been discovered; iron and limestone, and some other minerals are mined. Forest coverage is less than the national average, and the population of wild animals has been reduced significantly.

Climate

Average temperatures in August: High 84° to 88° F, Low 67° to 71° F

Area

16,800 square kilometers (6,487 square miles)

Source: www.travelchinaguide.com, www.citsusa.com/currency

macroeconomic environment in china

China is now the sixth-largest economy in the world, with GDP of \$1.4 trillion. Inbound foreign direct investment totals \$1 billion per week. China's rapid growth is challenging its physical infrastructure, including roads and rail, natural energy and utilities. Widespread power outages resulting in plant closures are expected this year.

Inflationary pressures are also increasing in China, with rising prices for raw materials, grain and labor.

Foreign investment in two key services sectors, financial services and logistics, both required for competition and development, are restricted but continue to increase.

Concerns remain about weaknesses in the banking sector and inefficiencies in capital allocation. Unrestrained lending practices have contributed to overcapacity and related deflationary risks. Analysts also anticipate a shift in China's currency regime that will have the effect of revaluing the yuan against the dollar around the middle of 2004, causing a 6% appreciation

against the dollar by the end of the year. Once China revalues, monetary authorities elsewhere in Asia will likely allow their currencies to appreciate against the dollar.

China's economic trends will influence markets globally. The risks present in its economy, and the resulting volatility in prices, offer an uncertain market for China trade and manufacturing.

Source: Excerpted from *JPMorgan Bulletin*, "Textile and Apparel Quota Elimination in 2005."

For more information, or to obtain a copy of the bulletin in its entirety, contact Kirk Stirling at 212.552.5128 or at kirk.stirling@jpmorganchase.com

pensions, endowments and foundations find

Whether due to market downturns, historically low interest rates, or increasing pressure to meet financial obligations, more and more pension funds, endowments and foundations are viewing securities lending as a viable means to gaining a competitive edge and delivering on their promises.

For many of us, the very mention of pension funds, endowments and foundations calls to mind those prudently run institutions, dedicated to safeguarding their members' contributions and investing them wisely so as to build and preserve a sizable stable of assets. In times past, however, "prudence" sometimes precluded considering opportunities to achieve profits or revenue beyond the conventional.

Within the last decade, that has changed. Spurred in part by the bear market of 2000–2002, low interest rates, heightened market volatility and overall competitive pressure to generate favorable returns, lending assets — as well as borrowing to boost them — has become an integral part of many a prudently run pension fund, endowment or foundation.

The reason is simple. "The primary driver to lend for these entities is virtually the same as for any asset manager — the ability to earn incremental income," says Bob Betz, manager New Business Development, JPMorgan Investor Services Securities Lending.

"We can provide a wide range of choices through our ability to construct

Certainly, while the recent lags in investment performance and funding requirements from both U.S. stocks and bonds in recent years have provided a natural impetus for pension funds to incorporate lending into their overall asset management activities, the evolution in the securities lending industry itself has provided incentive too. One example of such an incentive is the overall flexibility in terms of program management that firms such as JPMorgan offer.

"Lending has undergone a subtle but significant turnaround in the past decade or so, in terms of how pension funds perceive it as a source of revenue," says Tom Christofferson, business executive for the Institutional Investors Group, JPMorgan Investor Services Global and North American Client Management.

Specifically, Christofferson says that many current JPMorgan pension clients as well as other U.S. pension funds are attracted to JPMorgan's lending program due to its ability to customize lending agreements and program guidelines to meet each client's risk preferences. "This increased interest in securities lending is due, in large part, to the flexibility we are able to provide in terms of dealing with clients' specific risk parameters around collateral reinvestment. Now, more than ever before, clients can set their own tolerance, or establish a program around the risk/reward trade-off that they're seeking to obtain," Christofferson adds.

Overall, the program's increased options seem to offer the right mix for the pension, endowment and foundation market segment. "Whether in terms of collateral reinvestment guidelines, or in putting the various and diverse assets pension clients have in their portfolios to work via the strategies we offer, or through the potentially different kinds of collateral we can consider, we provide a wide range of choices through our ability to construct dedicated lending arrangements," he says.

growing appeal in securities lending

Competitive Edge at Hand

According to some pension fund managers, lending activity is no longer regarded as a peripheral activity, but rather is viewed as a reliable and valuable source of incremental income.

"We've been using JPMorgan's Securities Lending program since we became a custody client in 1995," says Kathy Reissman, CFA and director of investments for Texas Employees Retirement System. "At the time we had some stringent statutes in place that not only required us to be indemnified against borrower default, but also against reinvestment risk. Most securities lending operations weren't willing to provide that, but JPMorgan did. Further, once we were successful in getting those statutes changed, it really freed up the Securities Lending team to do more with our securities."

For many fund managers, the incremental income potential is serious business. For a fund manager competing within a tightly risk-controlled band versus a given benchmark, an additional 15 basis points of return could mean the difference between trailing and outperforming most of one's peers within a similar allocation. While some pension funds do not permit their investment managers to include lending income in performance measurement, others do, making the option all the more attractive.

"One of the things I like most about the program JPMorgan has put in place for our funds is that it's fairly conservative," Reissman explains. "We aren't looking to be exposed to a great deal of risk. Where we don't expect to see extremely

dedicated lending arrangements."

high returns, our securities lending activity generates a meaningful amount of dollars relative to our operating budget, which is very helpful," she continues. "Our experience has been very positive; they've delivered what they promised."

Scale Appeals to Smaller Funds

Another reason for pension funds' heightened interest in lending over the past decade is that the securities lending industry has widened its overall offerings to permit smaller pension funds — not traditionally a typical lending client — into the fold.

"In the past, securities lending was typically associated with larger plans," says Gene Picone, global head of Securities Lending, JPMorgan Investor Services. However, Picone explains that JPMorgan took active steps to offer smaller plans an opportunity to profit. "We have long held the view that customized collateral accounts present the best option for clients when it comes to maximizing revenue," he concedes. "However, with thin spreads currently in the marketplace and with interest rates continuing to remain historically low, we have revisited our own strategy, realizing that there are times when clients — who perhaps have smaller pools of cash — may not necessarily benefit from a pure distribution strategy."

One component making JPMorgan's Securities Lending program more attractive to smaller pension funds is the creation of a commingled investment fund in 2003, specifically designed to serve ERISA plans with smaller asset pools. The fund today holds \$1.8 billion in collateral, and offers a yield 17 basis points over the target rate, typically benchmarked against the U.S. Federal Funds Rate. JPMorgan followed this in May 2004 with a second commingled vehicle, aimed at serving other types of institutional investors including non-ERISA endowments, foundations and mutual funds who have less than \$300 million in cash collateral.

“Typically, clients with smaller plans generate smaller cash collateral balances. In order to assure proper cash collateral liquidity, investments are made on a very short basis with a short weighted average maturity; the smallest portfolios are solely invested in overnight maturities,” explains Gene Gemelli, manager Western Hemisphere Relationship Management, JPMorgan Investor Services Securities Lending. “As a result, the yield generated on that cash is low, and with a low yield a lender may be precluded from making loans of securities that demand relatively high rebates.” This is due to the spread between the investment and the rebate being simply too small or zero.

“When we commingle that cash into much larger pools, however, the yield issue is addressed, and JPMorgan is free to use a longer, yet still prudent, weighted average maturity on the pooled investments,” he adds. As a result, prospective clients, that may have previously feared their portfolios were too small to participate in lending, can now generate significant earnings.

First Things First: Understanding the Risks

While macro conditions were ripe for pension, endowment and foundation clients to consider lending, they first had to gain understanding and comfort about lending *per se*. “It was time for this client base to confront the facts about the potential risks and rewards of lending activity, and realize how lending could potentially mean the difference between trailing your peers and outperforming them,” says Gemelli.

“Essentially there are three core risks inherent in lending,” he says. “The first is operational and settlement risk, or the potential for processing mistakes and errors. This is generally the least of clients’ concerns, since security industry settlement infrastructure, combined with refined

procedural and system processes, have greatly reduced this risk. The second is counterparty risk, or the risk of an insolvent borrower failing to return borrowed securities (including non-cash distributions).” This risk is significantly mitigated by daily marking-to-market to maintain full collateralization, as well as by JPMorgan’s extensive indemnification, according to Gemelli.

“JPMorgan’s indemnification against borrower default provides generally that, if the value of the collateral posted by the borrower is insufficient to replace the securities (or non-cash distributions) that have not been returned, the Bank will gross up the difference between the replacement cost and the value of the applicable collateral (net of any cash collateral investment losses),” he says. Indeed, one of the many positive developments emerging from the JPMorgan/Bank One merger is that JPMorgan’s capital base will grow from \$42 to \$69 billion. “This capital backs our indemnification,” says Gemelli.

The third risk inherent in securities lending is associated with incurring a loss on cash collateral investments.

A loss could result from an investment default, a lender’s instruction to liquidate an investment prior to maturity at a time of rising interest rates, a sudden need to return cash collateral (thereby creating a liquidity issue) or rebates spiking above the cash collateral yield (potentially resulting from a large loan/investment mismatch).

“Again, we have policy, systemic and client customized safeguards in place to manage this category of risk,” says Gemelli. The protections range from real-time compliance with each client’s specific investment guidelines, independent post-trade compliance and overlaid JPMorgan Market Risk Management Policies, such as assuring that at least some investments mature every day.

securities lending: what you should know

Understanding the basics of lending should include reviewing not only the processes involved, but most important, the risks inherent in any lending transaction, says Bob Betz, manager of New Business Development, JPMorgan Investor Services Securities Lending. “Our process with a prospective client begins with education. We don’t start by discussing numbers; we first explore their views of lending, and what their expectations are. Most crucial, however, is an in-depth understanding of the risks,” he stresses.

Betz explains that while the process of examining risk sources, methods of risk management and indemnification can require time and careful consideration, “It’s fully worth it,” he says. “When our exploratory process is complete, a potential client can then review bids and respond with specific questions as to how each bidder came up with its numbers. This enables a client to understand the differences among the programs offered by various lending agents.” Before an institutional investor becomes a JPMorgan lending client, he adds, “We aim to help them convert the proposed economic

result of any bid into an understanding as to whether or not the risks outweigh the potential incremental return that one bidder proposes over another.”

The Basics of Lending

Securities lending takes place when an investor lends securities from their portfolio to a borrower that needs those securities for various business purposes. In the case of pension funds, the borrower is typically a major broker-dealer that needs the securities — often on short notice — to cover a short position in its role as a market maker.

Not to be ignored is the depth of JPMorgan's short-term fixed income research capability, a key element in reducing the likelihood of a lender holding a defaulted investment. "We have a unique advantage among all our peers in that our investment management subsidiary — JPMorgan Fleming Asset Management — provides us with a depth and breadth of research which itself is supported by a number of different businesses," explains Jim Wilson, Investment Management executive, JPMorgan Investor Services Securities Lending. "We're leveraging our formidable infrastructure and the size of our institution to create, maintain and exploit this shared utility, that provides us with research far superior to that which we could obtain as a stand-alone business."

More Good News on the Horizon

The securities lending activities of plans subject to ERISA are poised to get a boost and have available even more profit opportunities, if regulations proposed by the Department of Labor ("DOL") become effective. The DOL's proposal would, for the first time, allow ERISA-governed pension plans to lend securities to U.K.-based borrowers and to take collateral for those loans denominated in either pounds sterling or euros. Currently, plans can lend only to U.S.-based borrowers and take collateral denominated in U.S. dollars.

According to Picone, who, along with other prominent industry executives in tandem with the Risk Management Association (RMA), has been working for over 10 years to get the rules changed, the greatest benefit will be from increased opportunities to lend international securities. "The new rules are coming in at just the right time," says Picone. "Foreign collateral has found a strong niche in the securities lending arena," he explains. Additionally, the new rules will likely lead to increased revenue for plans since "plans will either make more loans or receive a better fee for the same amount of loans," he adds.

Betz agrees, saying, "This change will give plans a greater opportunity to earn," since non-U.S. equities, for example, offer a higher revenue opportunity from a lending perspective than, say, domestic stocks. Some segments of the pension, endowment and foundation markets stand to benefit even more, particularly the public sector. "Many public pension plans, which for years have looked to ERISA and the DOL as their defacto regulators when it comes to lending, have portfolio structures that tend to favor higher concentrations in non-U.S. equities."

Indeed, if and when the new rule goes into effect, it is expected to have a substantial influence over the lending of international securities and fixed-income lending. According to Wilson, "We have many clients who participate in non-U.S. markets that are currently locked down to only having a reinvestment option in the States," he says. "This will open many new doors, offering the ability to manage across more asset classes, and thereby making this proposition very attractive to lenders."

Overall, the increased acceptance of lending among pension funds and the like continues to be driven by a favorable climate for lending, as new options become available and as programs such as JPMorgan's continue to meet the changing needs of this unique client base. Says Picone, "When a portfolio must sustain itself, as pension, endowment and foundation assets are required to do, and as competitive pressure from peers mounts, fund managers need to find reliable sources of income over time. It's no surprise that in recent years, pension executives have asked themselves, 'What are prudent managers doing in similar circumstances?'" The answer, Picone says, "They're lending." ○○○

The borrower provides collateral for the loan, typically equivalent to 102% of the value of the securities borrowed where the securities borrowed and the collateral are in the same currency and 105% where the securities borrowed and the collateral are in different currencies. The initial collateral is then marked-to-market throughout the term of the loan to assure, among other things, that no loan has less than 100% collateralization. This generally means that, during the term of the loan, further collateral must be provided by the borrower if the value of the lent shares rises

(or the value of securities collateral falls), while collateral must be returned to the borrower if the lent shares fall in value (or the value of securities collateral rises).

The lending agent invests the collateral, when in the form of cash, in relatively short-term securities that earn interest. A negotiated portion of this income is rebated back to the borrower, with the remainder shared between the lender and the lender's agent, according to the term of the agreement between them. Where securities or letters of credit are posted

as collateral, the borrower pays an agreed borrowing fee, which again is shared between the lender and the lender's agent in an agreed proportion. At the end of the loan, the lent securities are returned to the lender (and collateral is either returned to the borrower or allocated to other loans needing collateral).

Typically, where a prospective lender's custodian bank, such as JPMorgan, has substantial lending expertise, the custodian is appointed as the lending agent.

a review of pension regulatory

Pension plans have been the subject of unprecedented attention over the past few years, following the dramatic deterioration of funded status in the years 2000–2002. One positive result has been an impetus to reevaluate existing practices in investing, funding, and reporting. Two areas of review in particular have culminated in recent months, with the final approval of revised regulations for pension funding and financial reporting. We provide a brief discussion and analysis of these developments.

What Aspects of Pension Finance Do the New Rules Affect?

There are two separate developments:

- One impacts potential **valuation for funding purposes**, (i.e., cash contributions) by changing a key discount rate from a 30-year Treasury-linked rate to a rate based on investment-grade corporate bonds. The new rate will be higher, making liabilities look smaller, and pension plans look better funded.
- Another impacts **financial accounting for pensions** (i.e., pension expense) by requiring greater disclosure.



(A) Funding Changes

What Are the Minimum Funding Rules?¹

Funding requirements are governed by ERISA, the IRS and the PBGC, with a web of rules designed to ensure adequate funding while limiting tax deductions to the plan sponsor. We focus here on the **minimum contribution requirements**, as these are of greatest concern to most plan sponsors.

The **baseline contribution** for most pension plans in a given year is equal to **normal cost plus amortization** of costs related to unfunded actuarial liabilities.² Unfunded liabilities may arise due to changes in the liability (such as benefit increases) or in the assumptions used for valuation purposes (such as mortality tables).

Plans whose assets fall below 80% of the “current liability” (valued with a specific discount rate, discussed below) are subject to **additional funding charges** (AFC) based on the level of underfunding.³ Plans falling between 80% and 90% funded to the current liability *may* be subject to such charges if they were also less than 90% funded in the previous two years. These additional funding charges are made **in addition to the baseline contribution**.

As an alternative to the baseline contribution (plus additional funding charges), in any given year a plan may choose to contribute the **amount that plan assets fall short of 90% of the “current liability.”** The **“current liability” is therefore an important determinant of contributions under either method.**

The Current Liability Discount Rate

Due to the prominence of the current liability in minimum funding rules, the **discount rate used to value the current liability is a key variable** for contribution calculations. A relatively low discount rate causes higher contributions (due to a higher liability value, and therefore lower funded status), while a relatively high rate leads to lower contributions, all other things being equal. We discuss the original and revised current liability discount rate methodologies on the following page.

changes

ORIGINAL RULES: Prior to recent changes, the current liability had been discounted with a proportion (ranging from 90% to 105%) of a smoothed, four-year weighted average of 30-year Treasury yields.⁴ Most sponsors chose to use the 105% proportion in order to make liabilities, and resulting contribution requirements, smaller.

TEMPORARY RELIEF: Declines in the 30-year Treasury yield (and discontinuance of the 30-year Treasury) during an extremely difficult market environment prompted Congress to enact a measure of relief, via the Employee Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA), which took effect in 2002. The Act all owed for plan sponsors to generate a higher discount rate by using a larger proportion (up to 120%) of the four-year weighted 30-year Treasury in their calculation of pension liabilities for contribution purposes. This funding relief applied specifically to the plan years 2002 and 2003, expired in December 2003.

In the absence of Congressional action in 2004, the old rule (with up to 105% of the smoothed and weighted 30-year rate) would have applied once again. This would have caused a sudden drop in the discount rate at a time when many plan sponsors were struggling to regain ground. This fragile environment (and continued lack of 30-year Treasury issuance) prompted the approval of the most recent legislation.

NEW RULE: The **2004 Pension Funding Equity Act**, approved in April 2004, states that the current liability should be discounted with a four-year weighted average of a **long-term, high-quality corporate bond rate**. The rate is itself a composite of three different corporate bond indices, where the most recent yields are accorded the highest weight.⁵ Plan sponsors may use a proportion, ranging from 90% to 100%, of this weighted-average rate to derive the final discount rate; we expect most sponsors to use the 100% proportion. **This legislation is temporary with a new rule intended to be in place after December 2005.**

How Much Relief Does the New Rate Provide?

In Table 1, we present a comparative analysis of the discount rates and associated effects of the original, temporary (EGTRRA), and new (Pension Funding Equity Act) rules. For example, as of December 31, 2003 (for plan year 2004), the 4-year weighted average 30-year Treasury yield (not shown) was 5.26%, resulting in a **5.51%**

current liability rate given the original 105% multiplier.⁶ The smoothed and weighted corporate composite index yield, and new current liability rate, was **6.55%**. For a 10-year duration liability, this increase of 104 basis points (from 5.51% to 6.55%) translates into an approximate **10.4% decrease in the current liability valuation**.⁷ This means that a plan that appeared to be 80% funded under the “old” rules would now appear to be 89% funded instead. For 2004, the new regulation also provides even greater relief than the temporary EGTRRA rules (which would have produced an effective discount rate of 6.30%). Thus the extended relief provided through the change in discount rate methodology has the intended effect of buoying funded status for contribution purposes.

How Sustainable is the “Relief”?

If rates were to stay at current levels (as of June 2004), with a year-end market rate of 5.34% for the 30-year Treasury and 6.12% for the long-term corporate composite, **this year (2004) would mark the peak of the relief gained from the new regulations**. This is because the 4-year smoothed rate of 6.55% this year encompasses rates from the years 2000, 2001, 2002, and 2003 — and the year **2000 was a high-rate year, especially for corporate spreads**. For example, the spread between long-term corporate rates and the 30-year Treasury was 190bp in the year 2000, versus just over 70bp in June 2004.⁸ When the year 2000 “rolls off” of the calculation next year, the smoothed and weighted rates drop, and the corporate and Treasury-based rates converge to a more moderate spread. If rates were to remain stable, we would ultimately expect a relative improvement of 5% with the new vs. original rules (i.e., a 5% relative decrease in the liability value).

This smoothing effect means that **even if rates were to rise, we would expect a dip in the effective current liability rate** for plan year 2005. For example (not shown here), if we saw a parallel rise of 200bp in market rates from year-end 2003 through year-end 2005, we estimate that the new regulatory rate would drop to approximately 6.20% for plan year 2005 before starting to rise again.⁹ This coincides with the deadline for new legislation to take the place of the Pension Funding Equity Act.

What are the Implications for Pension Plans?

While the Pension Funding Equity Act offers funding relief, it is only a temporary solution. Tweaking discount rates does *not* change the value of the benefit payments for which sponsors are responsible. Most sponsors will have to pay eventually, and the question becomes whether to pay now or pay later. This legislation allows sponsors to take the “pay later” option, in favor of preserving corporate cash or investing elsewhere. However, companies with adequate cash flow may find it prudent to pay now, as contributions made today have the greater benefit of compounding over time — preventing further deterioration in funded status.

estimated **impact** of pension funding equity act

| Rates at End of Year: For Plan Year (PY) Ending: | 2002 2003 | 2003 2004 | 2004 (Est*) 2005 | 2005 (Est*) 2006 | If Rates Stabilize* |
|---|--------------|--------------|---------------------|---------------------|------------------------|
| End-of-Year Rate* | | | | | |
| 30-yr Treasury ^a | 4.92% | 5.07% | 5.34% | 5.34% ... | 5.34% |
| Corporate High Quality Rate ^b | 5.90% | 5.64% | 6.12% | 6.12% ... | 6.12% |
| Current Liability Rate (Smoothed & Weighted)^c | | | | | |
| Original Regulations ^d | 5.81% | 5.51% | 5.43% | 5.47% ... | 5.61% |
| EGTRRA Relief (PY 2002, 03) ^e | 6.65% | 6.30% | 6.20% | 6.26% ... | 6.41% |
| New Regulations (PY 2004, 05) ^f | n/a | 6.55% | 6.16% | 6.06% ... | 6.12% |
| New Regulations vs. EGTRRA Relief | | | | | |
| % Change in Liability Value: ^g | | -3% | 0% | 2% | 3% |
| New Regulations vs. Original Regulations | | | | | |
| % Change in Liability Value: ^h | | -10% | -7% | -6% | -5% |
| 80% Original Funded Ratio Changes to: | | 89% | 86% | 85% | 84% |
| 100% Original Funded Ratio Changes to: | | 112% | 108% | 106% | 105% |

* For illustrative purposes only, we assume here that rates do not change from June 1, 2004 on.

a. Treasury rate closest to 30-year maturity since discontinuation of 30-year issuance.

b. Simple average of the three rates to be used by the U.S. Treasury Dept. to derive the composite high-quality rate: Citigroup High Grade Corp AAA/AA 10+ yrs, Merrill Lynch US Corp AA-AAA 10+ yrs, and Lehman Bros. US A Long Credit.

c. For all scenarios, we assume the highest permissible multiple of the appropriate 4-year weighted average rate.

d. "Original" regulations were based on 105% of the 4-year weighted average 30-year Treasury. (Sample average annual 30-year Treasury rates: 2000: 6.01%, 2001: 5.49%, 2002: 5.33%, 2003: 4.91%, 2004: 5.19%, assume 2005-on: 5.34%).

e. EGTRRA relief expired in 2003. Based on 120% rather than 105% of the 4-year weighted average 30-year Treasury.

f. Pension Funding Equity Act approved in April-04 for plan years 2004 and 2005. Based on 100% of a 4-year weighted average of the composite high-quality corporate yield, to be announced monthly by the U.S. Treasury Department. (Sample averages: 2000: 7.90%, 2001: 7.08%, 2002: 6.71%, 2003: 5.78%, 2004: 5.93%, assume 2005-on: 6.12%).

g. Comparing liability value using "new regulations" vs. "EGTRRA" current liability rate. Assumes 10-duration liability.

h. Comparing liability value using "new regulations" vs. "original regulations" current liability rate. Assumes 10-duration liability.

Source: JPMorgan Fleming, Lehman Brothers, Bloomberg, Internal Revenue Service

(B) Accounting Changes

An entirely separate framework, dictated by the Financial Accounting Standards Board (FASB), governs the **annual accounting and disclosure** of pension plans (including pension expense, the pension-related cost charged to corporate earnings for a given year).

Under existing statements FAS 87 and 132, the following pension-related disclosures have been required to appear in the *notes* to the financial statements:¹⁰

- Development of annual pension expense, including service and interest costs, expected return on assets, and amortization of gains and losses
- Market value of assets (MVA, beginning of year and end of year, with detail on changes)
- Projected benefit obligation (PBO, beginning of year and end of year, with detail on changes)
- Accumulated benefit obligation (ABO), *only* for those plans where MVA falls below ABO
- Reconciliation of funded status
- Discount rate assumption
- Expected return on assets assumption
- Salary growth rate assumption

New Disclosure Requirements

In December 2003, FASB announced the following additional disclosure requirements, to be implemented for plan years ending after Dec. 15, 2003, unless otherwise noted.¹¹ All public and non-public companies must now additionally provide:

Asset Strategy

- The percent allocation to the following four categories: equity securities, debt securities, real estate, and other, with additional detail “encouraged,” but not required
- Return expectations for plan assets in aggregate, as well as a narrative description of the basis for determining expected returns, including general approach, use of historical returns, etc.
- Narrative description of investment strategy and target asset allocation (if applicable)

Liability Value

- Accumulated Benefit Obligation (ABO) total value — for *all* plans, regardless of funded status

Cash Flows

- Expected contributions for the next fiscal year
- Expected benefit payments for the next five years (to be implemented in 2004)

Interim Reporting

- Components of pension expense and adjustments to contribution expectations are now also required to be disclosed in interim reporting periods.

What Are the Implications of the New Requirements?

While the new disclosures are far from comprehensive (versus the many additional disclosures that had been under consideration), FASB reportedly aimed to improve disclosures while placing a high priority on ease of implementation; thus the new disclosures are not too burdensome or technical.

Asset-related disclosures will give the public a more robust understanding of the **investment strategy**. A narrative of the thinking behind the development of return assumptions coupled with target allocations will allow the public to better understand whether expected return on plan assets is reasonable. It will be interesting to see if the new requirements surrounding asset allocation *and* asset return assumptions will encourage sponsors to reduce their overall expected rate of return assumption, and whether increased transparency leads to either more tailored investment strategies, or to more similar allocations across peer groups.

Liability-related disclosures allow for a more meaningful assessment of the pension’s impact upon the plan sponsor. The ABO provides a more accurate estimation of the plans’ actual current obligation, since it (unlike the PBO) does not include the effect of future salary increases. This measure is more useful for debt-related analysis, and its disclosure will also allow better prediction of possible charges to owners’ equity (which can occur when assets fall below the ABO). These disclosures will be especially meaningful for the companies sponsoring plans which are very large relative to the size of the company, for the performance of these plans potentially exercises much more influence upon corporate variables.

Further, since the PBO (but not the ABO) includes projections of future salary increases for plan participants, the **ratio of the ABO/PBO** gives an indication of the relative maturity of the plan (e.g., a high ABO/PBO ratio indicates a mature plan).

Cash flow-related disclosures give an indication of liquidity needs — for both the plan sponsor (in terms of contribution requirements) and for the plan (benefit payouts).

While additional disclosures (such as liability duration) would have been useful, the new requirements are still a positive development for both the investor and plan

sponsor communities. These disclosures should not only improve analysts' understanding of plans' status, but should encourage companies to better consider liability characteristics when developing investment policy and strategy.

Summary

The stresses imposed upon pension plan sponsors beginning in the year 2000 prompted the review of some Fundamental regulatory frameworks, with major developments on the funding and accounting fronts over the past several months. The Pension Funding Equity Act provides a measure of contribution relief, softening the blow of contribution requirements, but that relief is expected to peak this year. Additionally, plan sponsors are now subject to more rigorous accounting disclosures, which we expect to give more clarity to pension funding issues and reinforce investment policy discipline. ○○○

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1. The description of funding rules provided here is for general discussion purposes only. Each plan will face specific requirements that are also influenced by prior contribution history, smoothing methods, plan structure, types of charges and credits, etc. Please consult your actuary for a projection of contribution requirements.

2. Normal cost is the growth in liability due to one additional year of service provided by active employees. For this baseline contribution calculation, the liability is valued with a stable discount rate determined by the plan (not the "current liability" rate).

3. The proportion of the deficit that must be contributed depends upon the level of underfunding, as described in IRC sec.412(l)(4). Specifically, where (assets/current liability) = CLFR, the "deficit reduction contribution" (DRC) = [30% - 40% * (CLFR - 60%)] * (100% - CLFR). The additional funding charges required in a given year would then be the excess of the DRC over the "baseline" contribution.

4. As written in U.S. Internal Revenue Code and ERISA. This weighted average is not of end-of-year rates, but of average monthly rates over each year. See footnote 5 for the exact formula.

5. The rate is calculated as follows: 40% (average composite yield from previous year) + 30% (average composite yield from 2 years ago) + 20% (average composite yield from 3 years ago) + 10% (average composite yield

from 4 years ago). This weighting scheme is the same as that used to smooth and weight the average 30-year Treasury rates in the original regulations. The new composite rate assumed to be an average of Citigroup High-Grade Corp AAA/AA 10+ yr. index, Merrill Lynch US Corp AA-AAA 10+ yr. index, and Lehman Bros. USA Long Credit index.

6. Note that this weighted average is not of end-of-year rates, but of average monthly rates over each year.

7. 10-year duration* 104 bp = 10.4%, where duration measures the sensitivity to changes in discount rate.

8. December 2000: 30-year Treasury = 6.01%, Long-term corporate composite = 7.90%. June 2004: 30-year Treasury = 5.19%, Long-term corporate composite = 5.93%. Source: Lehman Brothers and JPMorgan Fleming.

9. JPMorgan Fleming estimates for illustrative purposes only, subject to change without notice.

10. Other specific disclosures and accounting values are detailed in the FAS statements.

11. Please see www.fasb.org for the News Release, FAQ, and full text of Revised Statement 132.

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